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No. 7826

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

CALIFORNIA BARREL COMPANY, INC., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	}

BRIEF FOR PETITIONER.

Upon Petition to Review an Order of the United States Board of Tax Appeals.

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I.

ABSTRACT OF THE CASE.

1. PRELIMINARY STATEMENT.

The B company organized in February, 1924, and the C company (the taxpayer and petitioner herein) organized in December, 1925, both were California corporations engaged in the manufacture and sale of barrels and cooperage (Trans. p. 41, par. 7, p. 45, pars. 12, 14) owned and controlled by the same stockholders with like officers and directors (Trans. pp. 47, 48, 49, pars. 17, 18).

The B company in its income tax return for the calendar year 1925, claimed a loss of $846,461.85 (Ex.

4, Schedule B, on file herein) which, when a part of it was applied against income, left a statutory net loss of $504,502.66 which, under authority of Sec. 206(b) of the Revenue Act of 1926, it would have been entitled to deduct from its 1926 income and if not extinguished by that deduction it would have been entitled, under the same act, to deduct the remaining statutory net loss from its 1927 income.

The B company transferred all its assets and business to the C company as of December 31, 1925, in exchange for the redeemable preferred stock and the common stock of the C company (Trans. p. 46, par. 15). The preferred stock of the C company in the same principal amount as that theretofore issued by the B company went to the A company as B company's nominee (Trans. p. 46, par. 15, pp. 47, 48, 49, pars. 17, 18). The common stock of the C company went to the common stockholders of the B company as the latter's nominee (Trans. p. 46, par. 15, pp. 47, 48, 49, pars. 17, 18). The C company had been organized in December, 1925, to take over the assets and the business of the B company *under exceptional circumstances* to avoid any threatened discontinuance of the enterprise in which the B company had been engaged and which the C company thereafter continued (Trans. pp. 44, 45, pars. 11, 12). In its income tax returns for 1926 and 1927 the C company had claimed as the *alter ego* of the B company a statutory net loss representing the unextinguished net statutory loss asserted by the B company in its 1925 return. The return of the C company for 1926 was not questioned by the Commissioner and is not involved in the present proceeding.

The respondent, however, advised the petitioner, the C company, that the statutory net loss claimed by the C company for 1927 could not be allowed and asserted a deficiency in tax liability accordingly of $14,915.65. The reason assigned for this decision was that the B company and the C company were different taxable entities (Trans. pp. 9 to 16). From this decision the petitioner appealed to the Board of Tax Appeals for a redetermination of the asserted tax liability. After the case was submitted to the Board early in January, 1934 (Trans. p. 3), but before the Board rendered its decision in November, 1934, the Supreme Court rendered its opinion May 28, 1934, in *New Colonial Ice Co., Inc. v. Helvering,* 292 U. S. 435. The Board of Tax Appeals in deciding the present case said:

> "The facts and contentions here involved are similar to those in New Colonial Ice Co., Inc. v. Helvering, 292 U. S. 435. * * * Upon authority of New Colonial Ice Co., Inc., supra, we hold that petitioner, the 'C' company, is not entitled to a deduction in 1927 for any portion of a net loss sustained in 1925 by its predecessor the 'B' company. This conclusion obviates the necessity of determining the correct amount of the alleged net loss sustained by 'B' company" (Trans. pp. 22, 23).

The Board accordingly assessed a deficiency tax against the petitioner in the sum of $14,915.65 (Trans. p. 24).

In assuming that the facts and contentions in this case were similar to those involved in the *New Colonial Ice Co.* case, the Board, it is suggested, was in error.

In the *New Colonial Ice Co.* case, the court announced that, as a general rule two corporations, though the stockholders of the two were substantially the same, for tax purposes would be regarded as separate entities but that this general rule was "subject to the qualification that the separate entity might be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights". The petitioner suggests that such an exceptional situation is present in this case, as will be later developed herein, and that because the separate entity may be disregarded by reason of such an exceptional situation the petitioner and the B company may be recognized as the same taxpayer within the meaning of Sec. 206(b) of the Revenue Act of 1926. After the Board rendered its decision, this court in January, 1935, rendered its decision in *McLaughlin v. Purity Inv. Co.*, 75 Fed. (2d) 30, rehearing denied March 25, 1935, in which, on the authority of the *New Colonial Ice Co.* case, it refused to recognize two corporations as the same taxpayer within the meaning of Sec. 206(b) of the Revenue Act of 1926. The petitioner also suggests, for reasons which will be presently submitted herein, that its case is distinguishable on the facts from the *Purity Inv. Co.* case.

This case was tried below on an agreed statement of facts (Trans. pp. 38 to 53) and on Exhibits 1, 2, 3, 4, 5, 6 and 7 attached thereto. Exhibit 1 is set forth in the Transcript pp. 51, 52, 53. The original Exhibits 2, 3, 4, 5, 6 and 7 pursuant to an order of this court have been forwarded to and filed with the clerk of this

court. These original exhibits so filed herein are the income tax returns of the corporations concerned for the years 1924, 1925, 1926 and 1927.

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2. FEDERAL STATUTES INVOLVED.

Sec. 206(b) of the Revenue Act of 1926 (26 U. S. C. A. Sec. 937(b), Sec. 206, 44 Stat. 17) reads as follows:

> "If, for any taxable year, it appears upon the production of evidence satisfactory to the commissioner that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called 'second year') and if such net loss is in excess of such net income (computed without such deduction), the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year (hereinafter in this section called 'third year'); the deduction in all cases to be made under regulations prescribed by the commissioner with the approval of the Secretary."

Extracts from other Revenue Acts incidentally involved are set forth in Appendix "A" to this brief.

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3. QUESTIONS INVOLVED.

The questions raised here are questions of law.

(1) This case raises the right of the C company, under the special circumstances of this case, to deduct

from its 1927 income an unextinguished statutory net loss arising from a net loss sustained by its predecessor the B company in 1925. One question here, therefore, is whether the petitioner by reason of an exceptional situation in its case, which will be later disclosed, comes within the exception noted in the *New Colonial Ice Co.* case and whether, therefore, the practical identity of the B company and the C company may be acknowledged and both recognized to be the same taxpayer, within the meaning of Sec. 206(b) of the Revenue Act of 1926.

(2) Another question is whether this case on its facts is so distinguishable from the *Purity Inc. Co.* case that the decision in that case is not controlling here.

(3) Finally, a question is presented which concerns the time when the loss originally asserted by the B company and carried over as a statutory net loss by the C company was actually realized so as to form the basis for taxable gain or loss within the purview of the Revenue Acts. The determination of the time of this loss will also settle the amount of this loss, all the facts of the case being agreed upon.

II.

SPECIFICATION OF ERRORS TO BE RELIED UPON.

(1) The Board erred in making and entering its decision in this cause and in entering judgment in favor of the Commissioner and against the taxpayer.

(2) The Board erred in its conclusions of law and its application of the law to the facts.

(3) The Board erred in that the opinion, decision and order of the Board are contrary to the evidence and are not supported by the evidence.

(4) The Board erred in that the opinion, decision and order of the Board are contrary to the facts stipulated in this case and are not supported by the facts stipulated in this case.

(5) The Board erred in determining a deficiency against this taxpayer for the year 1927 amounting to $14,915.65.

(6) The Board erred in holding that the taxpayer hereinabove referred to as the 'C company was not entitled to a deduction in 1927 for any portion of a net loss sustained in 1925 by its predecessor hereinabove referred to as the B company.

(7) The Board erred in finding that the two corporations hereinabove referred to respectively as the B company and the C company were in fact distinct corporations.

(8) The Board erred in concluding that the said B company and C company were in law distinct corporations.

(9) The Board erred in concluding that the said B company and C company were not one and the same taxpayer.

(10) The Board erred in failing to find or conclude that there is no income tax due from the taxpayer for 1927.

(11) The Board erred in not accepting and stating as its findings of fact all the facts stipulated in this case as the basis for its said opinion, decision and order.

(12) The Board erred in that the opinion and decision of the Board, based upon the facts stipulated in this case, are contrary to law.

III.

ARGUMENT.

1. THE EXCEPTIONAL CIRCUMSTANCES OF THIS CASE.

The petitioner has suggested that there are exceptional circumstances in this case which bring it within the exception to the general rule announced and applied in the *New Colonial Ice Co.* case and has also suggested that the circumstances of this case differentiate it from the *Purity Inv. Co.* case. These circumstances will now be developed.

The B company caused the C company to be incorporated to meet a situation (Trans. p. 45, par. 12) brought about by the wrongful conduct of the California Secretary of State which threatened the continuous operation of the business enterprise of the B company. The organization of the C company and the transfer of its assets and business by the B company to the C company were not deliberate and voluntary acts in the same sense that the creation of a new company and the transfer to it of the assets of the old company in the *New Colonial Ice Co.* case were deliberate and voluntary acts.

The circumstances under which the C company was organized and the transfer was made by the B company to the C company were as follows:

The B company filed its articles of incorporation with the California Secretary of State February 15, 1924, who thereupon issued his certificate of the incorporation thereof (Trans. p. 41, par. 7). Its articles provided that its capital stock should consist of 18,000 shares divided into 9000 shares of redeemable preferred stock with a par value of $100.00 per share and 9000 shares of common stock with no par value, both having voting rights (Trans. p. 41, par. 7). A corporation might then be organized in California according to the literal terms of the statutory law with two classes of stock, one with and the other without a par value (Civil Code Secs. 290b, 290c, 290d, 290e and 290f, as amended California Stats. 1923, p. 621, Chap. 293, set forth in Appendix "B" to this brief).

Under date of July 29, 1925 (rehearing later denied), the Supreme Court of California rendered its decision in *Del Monte Light & Power Co. v. Jordan*, 196 Cal. 488. That case was a mandamus proceeding against the Secretary of State to secure a writ directing him to file certain amended articles of incorporation of the plaintiff. The plaintiff, it appeared, was a California corporation organized in 1919 with a capital stock divided into preferred and common shares, both having the same par value. The plaintiff in said proceeding, it appeared, acting under authority of the aforesaid provisions

of the Civil Code so added thereto in 1923, proceeded in August, 1924, to amend its articles of incorporation so as to provide for a capital stock divided into preferred and common shares, the preferred shares to have a par value, and the common shares to have no nominal or par value. When these amended articles of incorporation were presented to the Secretary of State for filing in his office—a step necessary to make them effective (California Civil Code Sec. 362, as amended 1921, Stats. 1921, p. 134, Chap. 134, set forth in Appendix "B" to this brief)—the Secretary of State refused to permit their filing in his office, and the application for a writ of mandate against him then followed. The court, in that case, denied the writ, holding that the sections so added to the Civil Code in 1923 were in violation of certain provisions of the California Constitution, to-wit, Secs. 3 and 12 of Article XII thereof. These sections referred to the voting rights of stockholders in a corporation and their proportional liability as stockholders for the debts and liabilities of the corporation. The decision determined that the provisions of these sections required that the capitalization of corporations, to give effect thereto, should be represented in shares of a single par value.

In 1925 and in 1926, by virtue of the provisions of certain California statutes (Calif. Stats. 1915, p. 422, Chap. 190, as amended Calif. Stats. 1917, p. 371, Chap. 215, excerpts from which are set forth in Appendix "C" to this brief) every corporation doing

an intrastate business in the State of California, with certain exceptions not pertinent to the instant case, was obliged to procure annually from the Secretary of State, a license authorizing the transaction of such business in the State and was obliged to pay the prescribed license tax therefor. This tax was graded according to the authorized capital stock of the company concerned and was due and payable on the first day of January of each year (Sec. 3). Notice of the tax for the succeeding calendar year was to be mailed by the Secretary of State to every corporation concerned on or before December first of each year (Sec. 9). Failure to pay the tax made the corporate rights, privileges and powers of a domestic corporation suspended and incapable of being exercised (Sec. 11). When the rights, privileges and powers of the corporation were so suspended every person who attempted or purported to exercise any of the rights, privileges or powers of such a corporation was guilty of a misdemeanor and punishable by substantial fine or by imprisonment or by both and every contract made in violation of the statute, the statute itself expressly made void (Sec. 11).

Following the decision of the California Supreme Court in *Del Monte Light & Power Company v. Jordan,* supra, the B company tendered to the Secretary of State of the State of California, its amended articles of incorporation, providing that its shares of common stock, as well as its shares of preferred stock, should have a par value of $100.00 per share (Trans. p. 44, par. 11). The Secretary of State, acting

on the advice of the Attorney General, refused to permit the B company to file said amended articles of incorporation, on the ground that the B company was neither a *de jure* nor a *de facto* corporation (Trans. p. 44, par. 11). The Secretary of State, acting on the advice of the Attorney General, also refused to issue to the B company the statutory license to do business in California, during the year 1926, required by said statutes of 1915 and 1917, when in due time in the month of December, 1925, the prescribed license fee was tendered to him (Trans. p. 44, par. 11).

It was to meet the foregoing situation that the B company caused the C company to be incorporated on December 19, 1925, as aforesaid (Trans. p. 45, par. 12), and transferred its assets to the C company as of December 31, 1925 (Trans. p. 46, par. 15).

The circumstances of the B company at this juncture were such that it could not risk any actual or threatened interference with its continued business operations. To understand those circumstances fully it is necessary first to go back to the organization of the B company.

The B company had been organized in 1924 by the directors of the A company as its incorporators (Trans. p. 42, par. 8). The A company, a California corporation, had been organized in 1906 to engage in the manufacture and sale of barrels and cooperage (Trans. p. 39, par. 2). On August 28, 1924, with the authority of its directors, stockholders and all its creditors, the A company transferred all its business

and properties to the B company in exchange for 9000 shares of its preferred capital stock, par value $100.00 per share, and 995 shares of its common no par value stock which went to the stockholders of the A company as its nominees (Trans. p. 42, par. 8). This transfer of assets from the A company to the B company in exchange for stock was made to make provision for the payment of debts to certain creditors of the A company aggregating in excess of $1,000,000.00. These debts arose out of the stockholders' liability of the A company as a stockholder of an insolvent California corporation which had discontinued its business in 1922 (Trans. p. 43, par. 9). The preferred shares of the B company thus received by the A company were redeemable shares carrying accumulated dividends at specified rates supported by a sinking fund (Trans. p. 41, par. 7). The A company under the terms of a trust agreement made by it with The Bank of California National Association as Trustee, agreed to pay over to the Trustee all payments received by it from the B company whether dividends or redemption payments such Trustee to pay out the same ratably to the creditors of the A company therein listed as beneficiaries of the trust. So far as the preferred stock of the B company was concerned, A company was in effect a holding company. The common stock of the B company was owned by the stockholders of the A company. The A company and the B company were controlled and owned by the same group of individuals and they all had a common interest in keeping faith with the creditors of

the A company who had been provided for by this trust agreement.

In addition the business interests, the investments, and the financial obligations of the B company were substantial. The B company in its income tax return for 1925 (Ex. 4), disclosed an inventory at the beginning of the year of $370,239.72, an inventory at the close of the year of $407,422.97, with total assets of $1,582,714.34, including machinery and equipment of $407,744.29, and a bonded debt of $194,000.00 and a mortgage debt of $1800.00, and notes and accounts payable amounting to $173,659.05.

The possible effect of the decision in the *Del Monte Light & Power Co.* case on the corporate character of the B company concerned not only the creditors of the A company who had to look to the B company for any realization on its preferred stock, but it also concerned the direct creditors of the B company, as well as the stockholders of that company and its future business enterprise. If the B company had been so wedded to a capital stock structure with par value preferred shares and non par value common shares that it could suffer no divorce therefrom, it might have solved the dilemma as the *Purity Inv. Co.* did, by organizing a new corporation under the Nevada law with such a stock structure. The first reaction of the B company to the decision in the *Del Monte Light & Power Co.* case was not to invoke the law of another jurisdiction but was to make an effort to put its own house in order and through an amendment of its articles of incorporation to change its

capitalization to one represented by shares of a single par value and thus to harmonize its capitalization with the provisions of the California Constitution.

Such amended articles of incorporation the Secretary of State refused to permit the B company to file in his office on the grounds that the B company was neither a *de jure* nor a *de facto* corporation. Until filed in his office these amended articles of incorporation were without effect (California Civil Code 362 as amended 1921, supra). The Secretary of State, however, should have permitted the B company to file these amended articles of incorporation. Later, in a decision rendered May 19, 1926 (rehearing later denied), in *Westlake Park Investment Co. v. Jordan*, 198 Cal. 609, 618, the court held that the plaintiff in that case, a California corporation organized in 1925 with a capitalization like that of the B company represented by preferred shares with a par value and by common shares with no par value, was nevertheless a *de facto* corporation and as such entitled to amend its articles of incorporation and to file them in the office of the Secretary of State as so amended. Had the Secretary of State, in the latter part of 1925, not been misguided as to the law when the B company presented its amended articles of incorporation for filing in his office, and had he filed the same the problem of the B company would have been solved. By so amending its articles of incorporation as it attempted to do, the B company would have cured the irregularity in its original incorporation and have acquired a capitalization

harmonious with the provisions of the California Constitution. There would then have been no necessity for organizing the C company.

Following this refusal of its amended articles of incorporation the B company in December, 1925, tendered its license fees for 1926 and requested the statutory license to do business in California in 1926. The fees were refused and the license denied by the Secretary of State on the grounds and under the advice of the Attorney General already referred to (Trans. p. 44, par. 11). The Secretary of State had no right to refuse these fees or to deny this license as was subsequently determined in the *Westlake Park Investment Co.* case, supra. The penalties to which the B company and its officers would be exposed if it attempted to transact business in 1926 without paying its license fees and securing a license have been noted above. Not only would its officers and employees be liable to criminal prosecution but its contracts made in 1926 would be void. The business, the investment, and the financial obligations of the B company were too substantial to be thus left in jeopardy. To continue the business in 1926 it was essential that the B company should be free to exercise its rights, privileges and powers as a corporation and should be free to make, perform and enforce contracts without risk of penalty to itself or its officers or employees, and without having the validity of its contracts open to question. But there was no such court decision as that in the *Westlake Park Investment Co.* case to govern the situation as the year 1925 approached its close. The B company had done

what it could to avoid the creation of the C company. It had amended its articles of incorporation to conform its capital stock structure to the standards insisted upon by the court in the *Del Monte Light & Power Company* case, but it had not been allowed to file them so as to make these amended articles effective. It had requested a statutory license to do business in 1926 and tendered the prescribed fee therefor in due time and had been denied the license. The B company desired to avoid a disruption of its business from and after January 1, 1926. It wished to avoid the expense, delay, and uncertainty of possible litigation over its future contracts. It wanted to avoid placing itself and its officers and employees in possible jeopardy of the penalties prescribed by the licensing statutes of the state. It sought a way to continue with its business enterprise. It felt obliged to protect the interests of its stockholders and its creditors. It was anxious to conserve its property interests. In order to act in good faith toward all concerned with its enterprise it was not only necessary but imperative for it to take some immediate action. Accordingly, it provided for the creation of the C company and the transfer of its assets to the C company as of December 31, 1925. That course, we think, must be evident as the only safe, certain and prompt solution of the problem with which it was confronted. The time elements did not permit any other course. That the C company was created to meet this situation arising from the *Del Monte Light & Power Company* decision and the refusal of the Secretary of State to permit the B company to amend its articles

of incorporation, as aforesaid, and his denial of a statutory license to the B company for 1926 is not only stipulated herein (Trans. pp. 44, 45) but that the creation of the C company and the transfer to it of the assets of the B company had no other motive, is, we suggest, further evident from the substantial identity of the B company and the C company in all essential matters. The C company, except that in form it was a new entity, was in no essential different from what the B company would have been if the latter had been permitted in 1925 to file its amended articles of incorporation.

The C company, like the B company, issued nine thousand (9,000) shares of preferred stock to the A company (Trans. p. 42, par. 8, pp. 46, 47, par. 15). The A company upon receipt of these nine thousand (9,000) shares of the preferred stock from the C company executed with respect to them a trust agreement with The Bank of California National Association of San Francisco, as Trustee, similar to the trust agreement of which the preferred shares of the B company were the subject (Trans. pp. 41, 42, par. 7, pp. 45, 46, par. 14). The ultimate beneficial interest in the nine thousand (9,000) preferred shares of the B company was the same in the nine thousand (9,000) preferred shares of the C company. Both sets of shares had the same par value and the same preferences (Trans. pp. 41, 42, par. 7, pp. 45, 46, par. 14).

The preferred shares and the common shares of the B company and the C company, both had voting rights (Trans. pp. 41, 42, par. 7, pp. 45, 46, par. 14).

The C company operated under the same management as the B company (Trans. pp. 47, 48, par. 17, pp. 48, 49, par. 18).

The stock of the two companies immediately before and immediately after the transfer of the assets of the B company to the C company, effective December 31, 1925, was held as stated below (Trans. pp. 47, 48, par. 17, pp. 48, 49, par. 18). All of the stock of the B company was held by the A company or its stockholders directly or through B. J. Critcher, trustee, and all of the stock of the C company was held by the A company or its stockholders directly or through B. J. Critcher, Trustee, except that one qualifying director's share in the C company was held only temporarily by White, and later taken over by Krohn, a stockholder of the A company. Further the stock of the B company and the stock of the C company was not only thus owned by the same interests, but the capital stock liability of both was substantially the same, as appears from a comparison of Ex. 4 with Ex. 6, after allowing for preferred stock redeemed September 30, 1926, in the sum of $27,000.00 (Trans. p. 47, par. 16). The total capital stock liability of the B company and C company at the beginning of 1926, and before any redemption of preferred stock varied therefore by only $125.00, due probably to the fact that B company common stock had no nominal or par value, while C company common stock had a par value of $100.00 per share, and an effort was made to avoid fractional shares.

The A company owned the total authorized preferred stock of the B company and also of the C company, that is nine thousand (9,000) shares in each. Those ultimately beneficially interested in the preferred stock of the B company and in the preferred stock of the C company under the trust agreements referred to are the same, as already noted. Frederick J. Koster owned 50.6 per cent of the common stock of the B company and 49.41 per cent of the common stock of the C company. B. J. Critcher, Trustee, owned 49 per cent of the common stock of the B company and 49.02 per cent of the common stock of the C company. The A company owned 97.24 per cent of the voting stock of the C company until September 30, 1926, when with the retirement of 270 shares of preferred stock it held 97.16 per cent of the voting stock of the C company, which it continued to hold through 1926 and 1927 (Trans. p. 47, par. 16). Expressed in dollar values the common shares of the B company and the C company would be reflected as follows:

Stockholder	B company shares	C company shares
Frederick J. Koster	$12,939.75	$12,600.00
B. J. Critcher, Trustee	12,433.75	12,500.00
Four directors other than Frederick J. Koster	101.50	400.00
	$25,375.00	$25,500.00

As the directors of California corporations in 1925, 1926 and 1927, must have been stockholders (Calif. Civil Code Sec. 305, as amended 1905, Stats. 1905 p.

503, chap. 305, set forth in Appendix "B" to this brief) the foregoing distribution was as substantially identical on a valuation basis in the holdings of common stock in the B company and the C company, as was practically possible, if fractional shares were to be avoided, with a stock having a par value of $100.00 per share.

The C company continued the business of the B company with the property taken over from the B company, as is reflected in the income tax returns (consolidated) of the A company and the C company for 1926 and 1927 (Exs. 6 and 7), when compared with the income tax return of the B company for 1925 (Ex. 4).

Every effort was therefore made to make the C company and the interests therein as like as possible to the B company and the interests therein, and it must be apparent therefore that the only motive in organizing the C company was that motive which has been stipulated herein, namely, to meet the situation created by the unlawful conduct of the Secretary of State in refusing to file the offered amended articles of incorporation of the B company and in denying the latter a license for 1926.

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2. THE DISTINCTION BETWEEN THIS CASE AND THE PURITY INV. CO. CASE.

In the *New Colonial Ice Co.* case the bare bones of the case was one where the old company freely and voluntarily organized a new company and transferred

to it the assets of the old company for stock in the new which became the property of the stockholders of the new company in substantially like proportions to their holdings in the old company. For purposes of claiming a statutory net loss in 1922 and 1923 the new company based its claim on a net loss suffered by the old company in 1921. The court held that the new company was not the taxpayer who had suffered the loss and was therefore not entitled to claim the statutory net loss in 1922 and 1923 under Sec. 204(b) of the Revenue Act of 1921. In the course of its opinion the court commented on the fact that "the transaction was voluntary and contractual and not by operation of law". In the supporting cases cited by the court in that decision and in the cases referred to therein with comments of disapproval the transactions were all voluntary. The same may be said of the cases which we have examined which have since cited and followed the decision in the *New Colonial Ice Co.* case. In none of them have we found a case where the new organization was not the result of free and voluntary action unaffected by such forces of compulsion as existed in the case at bar unless it be the *Purity Inv. Co.* case. That case, however, upon analysis, reveals that the formation of the new corporation there was the result of voluntary action on the part of those concerned with free opportunity of a choice and that the motive of the organizers was not to preserve the identity of the old company but was very frankly to bring forth a new and distinct entity. This court, therefore, properly declined to distinguish

the *Purity Inv. Co.* case from the *New Colonial Ice Co.* case.

The following circumstances distinguish the *Purity Inv. Co.* case from the case at bar and emphasize the point which the petitioner desires to make in its case.

The Purity Inv. Co. of Nevada was the holding company of the Purity Stores, Inc. of Nevada. The Purity Stores, Inc. of California was incorporated February 26, 1925, with a capital stock represented by preferred stock having a par value and common stock having non par value. It had secured permission from the Corporation Commissioner to issue its stock on March 17, 1925. Four months later, on July 29, 1925, the decision was rendered in the *Del Monte Light & Power Co.* case which, however, did not become final until thirty days later when rehearing was denied. Thereupon the Corporation Commissioner denied the Purity Stores, Inc. the authority to issue further stock. How much stock had been issued in the five months following the original authority of the Corporation Commissioner does not appear, but evidently not all which the original permit authorized. Whether the Purity Stores, Inc. ever tendered or paid to the Secretary of State its license fees for 1926 is not disclosed by the opinion, though reference is made to the Secretary's opinion that such corporations as the Purity Stores, Inc. were not *de facto* corporations and were not entitled to a license authorizing them to transact business. Apparently, however, the Purity Stores, Inc. continued to do business until December 31, 1926, when all of its assets were transferred to the

Purity Stores, Inc. of Nevada, incorporated there on December 27, 1926. After being denied authority to issue more stock by the Corporation Commissioner some time in the latter half of 1925, the California corporation continued to receive money on stock subscriptions and issued interim certificates therefor. The Purity Stores, Inc. of California did not, like the B company, make an attempt to amend its articles of incorporation to change its stock structure so as to harmonize it with the provisions of the California Constitution as interpreted in the *Del Monte Light & Power Co.* case. Following the decision in the *Westlake Park Investment Co.* case on May 19, 1926, rehearing denied thirty days later, the Secretary of State on June 22, 1926, addressed a letter to the Purity Stores, Inc. advising that under the decision in the *Westlake Park Investment Co.* case it was a *de facto* corporation and entitled to enjoy the privileges of a corporation until an action for dissolution was brought by the Attorney General pursuant to Sec. 358 of the Civil Code. The Purity Stores, Inc. of California must have known of its right to amend its articles of incorporation under authority of the decision to which its attention was thus directed, and thereby conform its stock structure to constitutional requirements and acquire a *de jure* character free from the threat of *quo warranto* proceedings. Such an amendment would have paved the road to a new permit from the Commissioner of Corporations. The Purity Stores, Inc., however, attempted no such amendment of its articles and it took no such course because of its preference for a stock structure containing both par

value and non-par value stock. The Nevada corporation was organized to take over the property of the California corporation because under the Nevada law such a stock structure as was desired was permissible and because as this court truly observed the Nevada corporation "was incorporated for the sole and only purpose of preserving the stock structure adopted in California and which could not be maintained in California" (pp. 31, 32).

In making that choice in December, 1926, the Purity Stores, Inc. was acting freely and voluntarily and under no such compulsion as affected the B company in December of the year before. The Purity Stores, Inc. in December, 1926, knew that its *de facto* character was recognized by the courts and by the officials of California, knew that on paying its license fees it was entitled to a license to do business. It was subject to dissolution on *quo warranto* proceedings under Sec. 358 of the Civil Code but, though such proceedings were possible, the probability of such proceedings was very likely less of a moving factor in the decision of the Purity Stores, Inc. to incorporate in Nevada than the difficulty of securing a permit from the Corporation Commissioner to issue classes of stock which were not authorized by law. It was, as this court recognized, the desire to preserve a stock structure with par value stock and non-par value stock that lead to the Nevada incorporation proceedings. In December, 1926, the Purity Stores, Inc. had a free choice. It could abandon its existing stock structure and by amendment of its articles of incorporation provide for such a stock structure as could be maintained in California and

thus remain a California corporation and preserve its identity; or by entering a foreign jurisdiction it could create a new and foreign corporation with the stock structure desired and bring that foreign corporation into California to take over the business and assets of the domestic corporation. In deciding in favor of creating a foreign corporation it is apparent that the parties concerned deliberately intended to create a new and distinct corporate entity. The Nevada corporation had the power and authority to maintain a stock structure and to issue stock in accordance therewith which the domestic corporation lacked and this difference alone was sufficient to differentiate the California and the Nevada corporation not only in law but in fact as two separate and distinct entities and therefore not the same taxpayer within the meaning of Sec. 206(b) of the Revenue Act of 1926 (*Marr v. United States,* 268 U. S. 536, 541, 45 Sup. Ct. 575, 577). Looking through form to substance this essential difference between the two corporations still remained. The choice of the Purity Stores, Inc. made in December, 1926, was not affected by the conduct of state officials influenced by mistaken views of the law of the state, nor was it forced by a desire to escape possible criminal prosecution or to avoid possible litigation over the sanctity of its contracts. It was not a choice exercised under compulsion either in the same sense or in the same measure as was the choice of the B company in December, 1925, and there were therefore not special circumstances that would warrant bringing the Purity Stores, Inc. within the exception to the general rule declared in the *New Colonial Ice*

Co. case. It was simply a choice between changing its stock structure in conformity with the policy of the California law as set forth in its constitution or finding some way of doing business here as a corporation with a stock structure which did not conform to such a policy. The Purity Stores, Inc. had the way pointed in a decision rendered May 21, 1926. It learned from that decision that a foreign corporation with a stock structure composed of a par value and non-par value stock could enter California and do business here (*Commonwealth Acc. Corp. v. Jordan,* 198 Cal. 618, decided May 21, 1926).

The B company's procedure was in striking contrast to that of the Purity Stores, Inc. The B company did not attempt to find some way to maintain a stock structure opposed to the policy of the state. On the contrary, it attempted to change its stock structure to conform to that policy by appropriately amending its articles of incorporation. As a *de facto* corporation it had the legal right to so amend its articles, as was declared in the *Westlake Park Investment Co.* case (p. 618). Under the provisions of Sec. 362 of the Civil Code as amended in 1921, supra, any corporation had the right to amend its articles to provide for any "amendment not contrary to law". But this right was denied it by the Secretary of State when it attempted to exercise it. As a *de facto* corporation it was entitled to a license to do business in 1926. But this license was denied it by the Secretary of State. When thus denied its legal rights it sought as the only sure, prompt, and practical course in the premises within the time limits available to preserve the con-

tinuity of its business enterprise, the organization of the C company under California law with a stock structure in harmony with the laws of California and in line with what it had attempted to do through amendment of the articles of incorporation of the B company. In form the C company was a new entity of course. But in substance the C company was but a duplicate of what the B company would have been had it been permitted in 1925 to file its amended articles with the Secretary of State as it was legally entitled to do, but the right to do which was denied it. There was no motive in the case at bar to create a new corporate entity as the result of a free choice. The action was not voluntary in the sense that the action of those concerned was voluntary in the *Purity Inv. Co.* case and in the *New Colonial Ice Co.* case. There is a substantial distinction between the present case of the petitioner here and the *Purity Inv. Co.* case.

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3. THE DISTINCTION BETWEEN THIS CASE AND THE NEW COLONIAL ICE CO. CASE.

The mere facts that the officers and stockholders of two corporations are substantially the same, that the two were organized for substantially the same purposes, and that the property and business enterprise of the one has been taken over by the other with no break in the continuity of the enterprise, with nothing more to establish the identity of the two, were held insufficient to establish the two corporations as a single taxpayer within the meaning of Sec. 204(b) of the Revenue Act of 1921 in the *New Colonial Ice Co.*

case where, as was the fact in that case, the transactions of the parties concerned producing that result were voluntary and where there was no exceptional situation justifying the court to look through form to substance and to recognize substantial identity in spite of formal diversity. But where circumstances might justify looking through form to substance it would be important that substantial similarity should be apparent.

If in the case at bar it be permitted, because of the exceptional situation, to look through form to substance, the substantial similarity between the B company and the C company is apparent. So far as such a factor has a bearing, that circumstance exists in the present case.

That there are occasions when the identity of two corporations as one will be recognized is, it is suggested, definitely stated in the *New Colonial Ice Co.* case. The petitioner in that case insisted (1) that "the continuity of the business was not broken by the transfer from the old company to the new", (2) that "the ultimate parties in interest—stockholders and creditors—were substantially the same after the transfer as before", and these contentions that court said might be conceded. The court replied to these contentions by saying, of the language of Sec. 204(b) of the Revenue Act of 1921,

> "Taken according to their natural import they mean that the taxpayer who sustained the loss is the one to whom the deduction shall be allowed. Had there been a purpose to depart from the general policy in that regard, and to make the right

to the deduction *transferable or available to others than the taxpayer who sustained the loss,* it is but reasonable to believe that purpose would have been clearly expressed. And as the section contains nothing which even approaches such an expression, it must be taken as not intended to make such a departure" (emphasis supplied).

It is obvious that up to this point in the decision the court is not considering the question whether the two corporations were substantially identical or whether, therefore, there was in substance only one taxpayer involved. The court up to this point was denying, without any consideration of alleged identity of the two corporations concerned, the right of a successor corporation to claim deductions in 1922 and 1923 for losses sustained by its predecessor corporation in 1921. This is even more obvious as the court proceeds with its opinion, for it says next,

> "We come then to an *alternative* contention that, even though the section be not as broad as claimed, the deduction should be allowed, because 'for all practical purposes the new corporation was the same entity as the old one and therefore the same taxpayer'" (emphasis supplied).

This alternative contention the court answered by saying,

> "Thereafter neither corporation had any control over the other; the old corporation had no interest in the assets or business, and the chance of gain and the risk of loss were wholly with the new one. Thus the contention that the two corporations were practically the same entity and therefore the same taxpayer has no basis, unless, as

> the petitioner insists, the fact that the stockholders of the two corporations were substantially the same constitutes such a basis."

The contention of the petitioner that for all practical purposes the new corporation was the same entity as the old and therefore the same taxpayer was not to be conceded under the circumstances unless, as petitioner contended, the fact that the stockholders of the two corporations were substantially the same was a proper basis for the identity contention. The court did not recognize the mere identity of stock interests as establishing the identity of the two corporations in the *New Colonial Ice Co. Inc.* case but the court in that case has, we suggest, clearly indicated that there might be exceptional circumstances under which it would recognize the identity of stock interests as sufficiently establishing the identity of two corporations as the same taxpayer within the meaning of Sec. 204(b) of the Revenue Act of 1921 and therefore within the meaning of the similar Sec. 206(b) of the Revenue Act of 1926 with which the petitioner here is concerned.

The court in the *New Colonial Ice Co.* case met the last contention of the petitioner in that case by replying,

> "As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems. Of course, the rule is subject to the qualification that *the separate identity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of*

public or private rights. But in this case we find no such exceptional situation—nothing taking it out of the general rule. On the contrary, we think it a typical case for the application of that rule" (emphasis supplied).

In support of that reply the court cites among other cases, the following,

Southern Pacific Co. v. Lowe, 247 U. S. 330, 38 Sup. Ct. 540;

Gulf Oil Corporation v. Lewellyn, 248 U. S. 71, 39 Sup. Ct. 35.

In the *Southern Pacific Company* case, that company owned all the stock of the Central Pacific Railway Company, including the stock registered in the names of the directors. A dividend declared by the latter in favor of the former out of surplus accrued prior to March 1, 1913, was held not to be taxable income of the former. Such a dividend the court found to be income in form only and not taxable. As the court said, "the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control".

In the *Gulf Oil Corporation* case, that company owned all the capital stock of certain other corporations concerned except the qualifying shares held by

directors. What was a dividend to the parent company in form was held not taxable income in fact. "It is true", the court said, "that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the facts that they were related as parts of one enterprise, all owned by the petitioner, that the debts were all enterprise debts due to members, and that the dividends represented earnings that had been made in former years and that practically had been converted into capital, unite to convince us that the transaction should be regarded as bookkeeping rather than as 'dividends declared and paid in the ordinary course by a corporation'. *Lynch v. Hornby,* 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149. The petitioner did not itself do the business of its subsidiaries and have possession of their property as in *Southern Pacific v. Lowe,* 247 U. S. 330, 38 Sup. Ct. 540, 62 L. Ed. 1142, but the principle of that case must be taken to cover this".

In the *Southern Pacific Company* case and in the *Gulf Oil Corporation* case the fact that the earnings out of which the dividends were declared had been made prior to March 1, 1913, under the principles of *Lynch v. Hornby,* supra, would have been no saving factor, were it not for the further fact that the circumstances of those cases justified looking beyond the separate technical entities to the substantial identity of parent and subsidiary companies. In these two cases the court did look through form to substance in applying the income tax laws. It did recognize the substantial identity of the

two corporations concerned in those two cases and enforced a practical application of the income tax laws with the recognition of the substantial identity of two corporations as the controlling factor.

In a number of cases the Supreme Court has declared that in applying income tax laws substance and not form should be regarded. Thus in *United States v. Phellis,* 257 U. S. 156, 42 Sup. Ct. 63, the court said:

> "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have under varying conditions followed the rule."

In *Weiss v. Stearn,* 265 U. S. 242, 44 Sup. Ct. 490, the court said:

> "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form."

It is true that the decisions in the above cited cases announcing the substance rule were concerned with the taxation of gains or alleged gains by stockholders through stock dividends and for that reason are not directly apposite here.

But it is suggested that when a case arises which by reason of an exceptional situation would not come

within the general rule applied in the *New Colonial Ice Co.* case but rather within the exception to that rule there acknowledged, the principle applied in other cases that substance and not form is to control would be applicable to such an exceptional case. This principle was not repudiated in the *New Colonial Ice Co.* case. On the contrary, it was declared in effect that there are cases where "for the protection of private rights" as the court phrased it, the identity of two corporations may be recognized, and their separate technical entities may be disregarded.

In the case of *McCann v. Children's Home Society,* 176 Cal. 359, the Children's Home Society of California was a charitable and benevolent organization. In December 1891, the persons conducting this organization had attempted to form a corporation under the provisions of Secs. 593 et seq. of the Civil Code. By the provisions of Sec. 594, Civil Code, as they read in 1891, the articles of incorporation of such a corporation had to contain a verified statement showing certain facts relative to the election of its officers. The articles of incorporation were duly filed and a certificate of incorporation was duly issued by the Secretary of State. "Thereupon said Children's Home Society of California carried on business as a corporation until 1908, when it was discovered that the original filing of articles of incorporation was invalid for want of the verification required by Sec. 594 of the Civil Code." The Children's Home Society of California, upon making the discovery noted in 1908, realized that it was not a *de jure* and was at

most a *de facto* corporation. Thereupon it caused new articles of incorporation to be filed in 1908, and took the other necessary steps to form a corporation under the laws of California by the same name "Children's Home Society of California".

The court found that the old corporation was not a *de jure* corporation, but that it was a corporation *de facto* (p. 363).

Various questions were raised in the case, one of them resting upon the claim that the old and new corporations were two separate and distinct entities. Upon this phase of the case the court said:

> "Throughout his brief the appellant insists upon treating the organization which attempted to file articles in 1891 as an entity separate and distinct from the corporation which was formed in 1908. In discussing the legal points made, we have gone upon the assumption that this position was well founded. It is proper to say, however, that the real situation disclosed by the evidence is that the same persons who were conducting the organization from 1891 to 1908 filed articles of incorporation in the latter year for the purpose of correcting the defects in the attempted incorporation of 1891. In fact the new corporation was a continuation of the then existing *de facto* corporation, and we are satisfied that if the question were material here, there would be no substantial difficulty in perceiving and declaring that the two organizations were in reality identical."

In this case the situation of the petitioner is even stronger than that of the second corporation in the *McCann* case. Here the C company had as the sole

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(a) Section 7204. "Reincorporation **** is not the same thing as reorganization **** Reincorporation **** consists in the taking out of a new charter by a corporation in order to correct errors or defects in the original incorporation or to enlarge the powers or limit the liabilities of the corporation, or to lengthen or revive the corporate life. In a sense it is but an amendment of the charter, and, generally under the statutes there is no new corporation but the company is the same as before the reincorporation."

(b) Section 7285. **** "A reorganization, as distinguished from a mere reincorporation, generally results in the bringing into existence of a new corporation with the consequent dissolution of the old one."

(c) Section 7286. **** "However reincorporation, as the term has already been defined does not, ordinarily, create a new corporation. Thus the filing of articles of incorporation to correct defects in a former attempted incorporation makes the new corporation merely a continuation of the existing de facto corporation."

motive for its origin a desire on the part of the parties concerned to protect their rights and to correct a defect in the articles of incorporation of the B company, a defect which the B company was entitled to correct through the amendment of its articles, but which, when it attempted to assert that right, was denied that privilege by the Secretary of State. If the California court in the *McCann* case would find no substantial difficulty in declaring the two corporations in form identical in reality, it can hardly be doubted that it would find no difficulty in declaring the B company and the C company in reality identical.

If, for the protection of private rights, courts are ever warranted in looking through form to substance and in recognizing the actual identity of two corporations as one and the same for any purpose, this case, it is suggested in all earnestness, is such a case.

The case at bar, we submit, is a case where under the exceptional situation which exists here the substantial identity of the B company and the C company may be recognized and where the two for the purposes of Sec. 206(b) of the Revenue Act of 1926 may therefore be recognized as the same taxpayer.

Such a recognition would call for a reversal of the decision of the Board of Tax Appeals, which rested wholly on the ground that the two corporations concerned were not, for the purpose of applying the income tax act, a single entity.

The balance of this brief is concerned wholly with the question of the petitioner's loss, when it was realized and what was its amount. If the court can-

not concur with the decision of the Board of Tax Appeals on the subject matter of corporate identity, the settlement of any question here about the loss remains for determination. If, on the contrary, the court concurs in the conclusion of the Board, the balance of this brief concerns a question which then need not be determined by the court.

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4. **WHEN THE LOSS WAS REALIZED. THE LOSS OUT OF WHICH THE STATUTORY NET LOSS ASSERTED BY THE C COMPANY ARISES WAS NOT REALIZED SO AS TO FORM THE BASIS FOR TAXABLE LOSS OR GAIN UNTIL THE SALE BY THE B COMPANY IN 1925 OF THE KOSTER PRODUCTS COMPANY STOCK.**

(a) **This loss was not realized upon the transfer of the A company to the Koster Products Company on May 31, 1919.**

As of May 31, 1919, the A company transferred to the Koster Products Company, a Nevada corporation, certain timber lands and plant in Oregon and Washington (Trans. pp. 39, 40, pars. 2, 3) whose adjusted cost at that time as stipulated was at least $738,374.21, if certain carrying charges were not a proper element of cost (Trans. pp. 51, 52 and 53). In consideration of this transfer the A company received 8000 shares of the capital stock of the Koster Products Company on the basis of a value of $50.00 per share, which was its fair market value at that time, making a total value of $400,000.00 (Trans. pp. 39 to 41, pars. 3, 4, 5, 6). The A company in its return for its fiscal year then ending June 30, 1919, claimed a loss on this sale, which was disallowed by the Commissioner of Internal Revenue on the ground

that the two companies were then affiliated and the transaction accordingly an inter-company one in which there could be no taxable loss or gain (Ex. 4, Schedule K, explanation of Balance Sheet). At the time of this transaction, May 31, 1919, the A company owned 84.29 per cent of the stock of the Koster Products Company and stockholders of the A company held 11.23 per cent of the stock of the Koster Products Company, between them thus holding more than 95 per cent of the stock of the latter company (Trans. p. 40, par. 5). There is nothing in the record before the Board or this court to establish that the A company did not actually control this 11.23 per cent of the stock held by its stockholders or that such actual control was not legally enforcible. The ruling of the Commissioner is presumptively correct and the petitioner relied and still relies upon that presumption. That ruling necessarily involved the Commissioner's determination that the A company owned directly or controlled through closely affiliated interests substantially all of the stock of the Koster Products Company, or that substantially all of the stock of the two companies was owned or controlled by the same interests (Sec. 240 (b), Revenue Act of 1918). This ruling made out a prima facie case of affiliation (*United States v. Rindskopf*, 105 U. S. 418, 422). The burden of overcoming this presumption, of impeaching this prima facie case of affiliation is on the respondent (*Germantown Trust Co. v. Lederer*, 263 Fed. 672, 676, 8th Cir.). Any attack on that ruling in this proceeding is a collateral and not a direct attack. There is nothing in the record here to overcome the

presumption of affiliation and the conclusion that the transaction was an intercompany one accordingly in which no taxable gain or loss was realized.

It was compulsory under Sec. 240(a) of the Revenue Act of 1918 for affiliated companies to file consolidated returns and not optional as under later acts. By the provisions of Treasury Regulations No. 45, Art. 636, inter-company transactions were to be eliminated in determining the combined taxable income of the affiliated corporations. There could, therefore, be no taxable gains or losses arising from such inter-company transactions.

(b) The loss was not realized upon the transfer by the A company to the B company on August 28, 1924.

On August 28, 1924, the A company transferred all of its assets and business, including said 8000 shares of stock of the Koster Products Company, to the B company for preferred and common stock of the latter (Trans. p. 42, par. 8) under circumstances which amounted to a reorganization within the meaning of Sec. 203 of the Revenue Act of 1924 in which, accordingly, no taxable gain or loss could be recognized.

Where a corporation like the A company transferred property to another company like the B company for its capital stock under the provisions of Sec. 204(a) (7) of the Revenue Act of 1924 (corresponding to Sec. 204(a) (7) of the Revenue Act of 1926 and to Sec. 113(a) (7) of the Revenue Act of 1932), the basis of the property in the hands of the transferee corporation (the B company) is the same

as it would be in the hands of the transferror (the A company).

L. H. Philo Corporation v. Commissioner, 16 B. T. A. 130, 50 Fed. (2d) 1079;

Mente & Co. v. Commissioner, 24 B. T. A. 401;

Flushing Nurseries Co. v. Commissioner, 25 B. T. A. 938;

Ridgewood Cemetery Co. v. Commissioner, 26 B. T. A. 626;

Newman, Saunders & Co. v. United States, 36 Fed. (2d) 1009; 281 U. S. 760; 50 Sup. Ct. 460;

Osburn California Corp. v. Welch, 39 Fed. (2d) 41; 282 U. S. 850; 51 Sup. Ct. 28.

The A company transferred all its assets to the B company in 1924 (Trans. p. 42, par. 8). Immediately thereafter the A company and its stockholders were in control of the B company, owning all of the capital stock of the B company, common and preferred, and all of the voting stock thereof (Trans. pp. 41, 42, pars. 7, 8). Both the common and preferred shares of the B company had voting rights (Trans. p. 41, par. 7). In consideration of the transfer to the B company, nine thousand (9000) shares of preferred stock of the B company were issued to the A company (Trans. p. 42, par. 8) and at the same time nine hundred ninety-five (995) shares of common stock of the B company issued to the stockholders of the A company, as its nominees (Trans. p. 42, par. 8). At the same time five shares of the common stock of the B company issued as qualifying shares to the directors and incorporators of the B company, who were also

directors of the A company (Trans. p. 42, par. 8). These five directors of the A company and of the B company were stockholders of the B company and, under California law, had to be stockholders of the A company. The remaining authorized capital stock of the B company remained unissued (Trans. p. 42, par. 8). Thus nine thousand (9000) shares of stock, preferred, was owned by the A company and one thousand (1000) shares of stock, common, was owned by the stockholders of the A company. The A company alone immediately after the transfer owned ninety per cent (90%) not only of all the voting stock, but of all the stock. An eighty per cent (80%) interest was sufficient to bring the A company and the B company within the provisions of Sec. 204 (a) (7) of the Revenue Act of 1924.

Such a situation constitutes a "reorganization", as defined by Sec. 203 (h) (1) (B) and Sec. 203 (i) of the Revenue Act of 1924. This situation also reveals both the A and the B company as a "party to a reorganization" within the meaning of the Revenue Act of 1924 (Sec. 203 (h) (1) (B) and (h) (2). The B company resulted from the reorganization. It was created by the directors of the A company (Trans. p. 42, par. 8) for the same purpose as the A company, namely, to engage in the manufacture and sale of barrels and cooperage (Trans. p. 41, par. 7). No stock was issued by the B company, not even the qualifying shares of its directors until the transfer to it of the assets of A company (Trans. p. 42, par. 8). This transfer was made under authority not only of the directors and stockholders of the A company, but

of all of its creditors (Trans. p. 42, par. 8). The transfer was made so that the business enterprise formerly conducted by the A company might be continued by the B company, free from the load of debt pressing on the A company, in the form of a stockholder's liability, the B company converting that into a capital stock liability, and thereby enjoying a better credit position for current obligations, than the A company had (Trans. p. 43, par. 9). Every step taken from the first formation of the B company to the final transfer to it of the assets of the A company and the resulting stock issues and the attendant trust agreement with the bank reveals a definite plan of reorganization to provide for those creditors whose claims were predicated on a stockholder's liability of the A company and to improve the credit position of the business enterprise. Not only did the B company thus result from the reorganization and become a party to it but the A company, acquiring ninety per cent (90%) not only of the voting stock, but of the total number of shares of all classes of stock, also became a party to the reorganization, within the meaning of the Revenue Act of 1924.

By the provisions of Sec. 203 (b) (3) of the Revenue Act of 1924, no gain or loss shall be recognized if a corporation a party to a reorganization—the A company—exchanges property in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization—the B company. Except as the B company agreed to assume certain debts of the A company the sole consideration for the transfer was the stock

of the B company (Trans. pp. 42, 43, pars. 8, 9). By the provisions of Sec. 203 (f) if an exchange would be within the provisions of Sec. 203 (b) (3), just referred to, if it were not for the fact that the property received in exchange consists not only of property (stocks and securities) permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

It is self-evident, therefore, that no taxable gain or deductible loss resulted from the transfer from the A company to the B company in 1924, and that the B company under Sec. 204 (a) (7) of the Revenue Act of 1924 was entitled on a future sale of the eight thousand (8,000) shares of the Koster Products Company to use the same base for determining the loss thereon as the A company.

The B company party to this reorganization though not a *de jure* was a *de facto* corporation and within the terms of the Westlake Park Investment Co. opinion heretofore referred to. The B company as a *de facto* corporation used its franchise as shown by its income tax returns for 1924 and 1925 (Ex. 2 and 4). The very issue of stock in 1924 is evidence of a user of its franchise and of its *de facto* character (*Midwest Air Filters Pacific Inc. v. Finn,* 201 Cal 587, 592; *Tulare Irr. Dist. v. Shepard,* 185 U. S. 1, 22 Sup. Ct. 531). As a *de facto* corporation it must, for all the purposes of this case, be recognized as a corporation within the meaning of Sec. 203 of the Revenue Act of 1924. A *de facto* corporation is not only a corporation in fact but also in law (*People v. La Rue,*

67 Cal. 526, 530; *McCann v. Childrens Home Society*, 176 Cal. 359, 363, Ballantine Private Corporations (1927) Sec. 26). The B company therefore though a *de facto* corporation, was a corporation and a party to a reorganization within the meaning of Sec. 203 of the Revenue Act of 1924 as fully as though it had been a *de jure* corporation.

The loss not having been realized in 1919 nor in 1924 the first occasion when a realizable loss could be asserted for the purpose of determining taxable gain or loss within the meaning of the Revenue Acts concerned, was on the sale of the shares of the Koster Products Co. by the B company in 1925.

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5. **THE AMOUNT OF THE LOSS, THE FACTS BEING STIPULATED, IS A QUESTION OF LAW. THE LOSS REALIZED ON THE SALE OF STOCK IN 1925 BY THE B COMPANY WAS SUFFICIENT AFTER THE DEDUCTION OF A STATUTORY NET LOSS BY THE C COMPANY IN ITS RETURN FOR 1927 TO LEAVE A PORTION OF THAT STATUTORY NET LOSS STILL UNEXTINGUISHED.**

Whether we take as the basis for determining gain or loss the adjusted cost of $908,201.85 used by the C company, which included carrying charges as one of the elements thereof, or the lower figure of $738,374.21 exclusive of those carrying charges, the net result is the same for in either case the resulting statutory net loss deductible from the 1927 income of the C company was more than sufficient to result in no tax (see Appendix E to this brief). The facts of this case are not in dispute. The case was by stipulation submitted on an agreed statement of facts.

Under such circumstances, had the board found facts not supported by the stipulation, it would be "the duty of the court to accept as the facts those disclosed by the stipulation and not the facts as found by the Board of Tax Appeals" (*Iowa Bridge Co. v. Commissioner,* 39 Fed. (2d) 777, 780—8th Cir.).

This case therefore can be fully adjudicated by this court. The question as to the amount of loss can be determined as a matter of law from the facts which have been stipulated. Upon this review of the order of the Board this court has "power to affirm or, if the decision of the Board is not in accordance with law to modify or reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require" (26 U. S. C. A., Sec. 1226, Sec. 1003, 44 Stat. 110).

By the agreed statement of facts it was stipulated that the adjusted cost of the properties of the A company as of May 31, 1919, which on that date was transferred to the Koster Products for its shares of stock, was as set forth in Exhibit 1 attached thereto and incorporated therein by reference (Trans. p. 39, pars. 2, 3). That Exhibit 1 (Trans. pp. 52 and 53) fixed that adjusted cost, less depletion and depreciation, at $738,374.21, exclusive of carrying charges, and conceded that the carrying charges amounted to $169,-827.64. The petitioner believed that as a matter of law these carrying charges should be included as an element of adjusted cost which would raise the figure to $908,201.85. For the purposes of this review the lower figure of $738,374.21 may be accepted without

any change in the result. It is true that the Oregon lands were acquired in 1919 and the other property in 1918, and that original cost, less depletion and depreciation, was the basis of reaching the stipulated adjusted cost. The question of adjusted cost was a factor in determining taxable loss on the sale of the stock of the Koster Products Company in 1925 by the B company and at that time the basis for determining gain or loss was declared in Sec. 204 (b) of the Revenue Act of 1924, which provided as follows,

> "The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913 shall be (A) the cost of such property * * * or (B) the fair market value of such property as of March 1, 1913 whichever is greater."

Cost, therefore, was the proper basis to be used as to all the property acquired in 1918 (after March 1, 1913). As to the Oregon property acquired in 1910, (before March 1, 1913) the proper basis was cost if that was the higher, or the fair market value as of March 1, 1913, if that was the higher. If the cost of the Oregon property was higher than its fair market value as of March 1, 1913, the cost was the proper basis. If its cost was lower than the fair market value the only one affected by using cost instead of value is the petitioner whose loss under those circumstances would be understated rather than overstated. The basis for determining taxable gain or loss to the B company in 1925 may therefore be taken at $738,-374.21, which less the $64,400.00 received for the stock

in 1925 makes a net loss of $673,974.21 and a statutory net loss in 1925 of $332,015.02 subject to carry over in 1926 and 1927, more fully shown in Appendix E, and more than sufficient to result in no tax to the C company on its 1927 income. If the A company had retained the Koster Products Company stock and sold it in 1925 for $64,400.00 the basis for establishing its net loss on that sale would have been $738,374.21. When the B company acquired this stock from the A company in 1924 in a transaction which amounted to a reorganization under Sec. 203 of the Revenue Act of 1924, upon the sale by the B company of this stock in 1925 for $64,400.00 its basis, too, for establishing its net loss on that sale was $738,374.21 (Sec. 204 (a) (7) of the Revenue Act of 1924).

The petitioner argued before the Board that the provisions of Sec. 204 (a) (7) of the Revenue Act of 1924 were not applicable because that section excluded "stock or securities in a corporation a party to a reorganization" and because he claimed that the Koster Products Company was a party to the reorganization resulting from the transfer from the A company to the B company in 1924 and that therefore only $15.00 per share was the proper basis of cost of this stock in determining loss on its sale in 1925. There is no point in this claim, if the Koster Products Company was not "a party to a reorganization". The Koster Products Company was not in fact nor in any fair interpretation of Sec. 203 of the Revenue Act of 1924 a party to the reorganization. The only parties to the reorganization in 1924 were the A company and the

B company, the only actors therein. In that reorganization the Koster Products Company was not consulted, nor was it in any way an active participant therein, nor did it receive anything therefrom.

Whether the respondent will renew that claim before this court we are not at present advised. If he does, we should like the privilege of answering him here as we did before the Board. We will not make further answer to this possible claim in the main text of this brief, but we have set forth our answer to that contention in Appendix D to this brief, not desiring to take the time of the court unnecessarily, if the point is not made, but preserving the right to make the reply thereto set forth in Appendix D, if the point should be made before this court.

IV.

CONCLUSION.

The circumstances of this case distinguish it, we submit from the *New Colonial Ice Co.* case and the *Purity Inv. Co.* case. They are, we believe, sufficient to warrant the recognition of the B company and the C company as a single entity and as the same taxpayer within the meaning of Sec. 206 (b) of the Revenue Act of 1926. The amount of the loss carried over as a statutory net loss in 1927 was more than sufficient to result in no tax for that year.

The court is accordingly requested to modify the order of the Board assessing a deficiency tax against

the petitioner in the sum of $14,915.65 and to adjudge, on the contrary, that there is no tax due or owing by the petitioner on its 1927 income.

Dated, San Francisco,
October 4, 1935.

Respectfully submitted,
ALLEN G. WRIGHT,
RANDELL LARSON,
Counsel for Petitioner.

(Appendices A, B, C, D and E Follow.)

(Appendices A, B, C, D and E Follow.)

Appendix A

PERTINENT EXTRACTS FROM REVENUE ACTS INVOLVED, NOT SET FORTH IN BRIEF.

1. *Revenue Act of 1918.*

Sec. 240 (b). For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

2. *Revenue Act of 1924.*

Sec. 203 (b) (3). No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

Sec. 203 (f). If an exchange would be within the provisions of paragraph (1), (2), (3), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

Sec. 203 (h) (1). The term "reorganization" means (A) a merger or consolidation (including the

acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

Sec. 203 (h) (2). The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

Sec. 203 (i). As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

Sec. 204 (a). The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913 shall be the cost of such property. * * *

(7) If the property (other than stock or securities in a corporation a party to the reorganization) was acquired after December 31, 1917, by a corporation in

connection with a reorganization, and immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Appendix B

PERTINENT EXTRACTS FROM CERTAIN CALIFORNIA CODE SECTIONS.

1. CALIFORNIA CIVIL CODE SECTIONS 290 b, 290 c, 290 d, 290 e AND 290 f, AS AMENDED STATS. 1923, p. 621, CHAP. 293.

Sec. 290b. Any private corporation created and existing or authorized to be created under the provisions of title one, part four, division first of the Civil Code may, if so provided in its articles of incorporation or in any amendment thereof, issue shares of stock of such corporation (other than stock preferred as to dividends or as to its distributive share in the assets of the corporation) without any nominal or par value by stating in its articles of incorporation or in such articles as so amended:

(a) The number of shares with a nominal or par value, if any, and the number of shares without a nominal or par value that may be issued by the corporation, and the classes, if any, into which such shares are to be divided, together with a statement of the distinguishing preferences, rights, privileges and restrictions of each class;

(b) The nominal or par value (which shall be the same for all shares, having a nominal or par value) of shares other than shares which it is stated are to have no nominal or par value;

(c) Either (1) the amount of stated capital with which the corporation will begin business, which amount shall not be less than five hundred dollars; and

that the corporation will carry on business with a stated capital which shall not be less than the aggregate amount of the preference to which all issued and outstanding stock having a preference as to principal is entitled, and in addition thereto an amount therein stated in respect to every share of stock issued and outstanding other than stock having a preference as to principal, which amount shall not be less than five dollars for each share, and such additional amount as from time to time may by resolution of the board of directors of the corporation be transferred thereto; or (2) the amount of stated capital with which the corporation will begin business, which in no event shall be less than five hundred dollars; and that the corporation will carry on business with a stated capital consisting of the aggregate of the amounts received by it as consideration for the issuance of its shares with no nominal or par value, the aggregate par value of all issued and outstanding shares, if any, having a nominal or par value, and such additional amounts as from time to time may by resolution of the board of directors of the corporation be transferred thereto.

Such statements in the articles of incorporation or such articles as amended shall be in lieu of any statements prescribed by the law under which the corporation shall have been formed as to the maximum amount of its capital stock or the number of shares into which the same shall be divided or the amount of the par value of such shares.

Subject to the preferences, rights, limitations, privileges and restrictions lawfully granted or imposed in

respect of any stock or class thereof, each share of such stock with no nominal or par value shall be equal to every other share of such stock. Every certificate for such shares without nominal or par value shall have plainly written or printed upon its face the number of such shares which it represents, and no such certificate shall express any nominal or par value of such shares or express any rate of dividend in terms of percentage of any nominal or par value. The certificates for preferred shares shall state the amount, if any, which the holders of each of such preferred shares shall be entitled to receive on account of principal from the assets of the corporation in preference to the holders of other shares, and shall state briefly any other rights or preferences given to the holders of such shares.

Subject to laws creating and defining the duties of the commissioner of corporations and to the law creating and defining the duties of the railroad commission, such corporation may issue and may from time to time sell its authorized shares without nominal or par value for such consideration as may be prescribed in the articles of incorporation or for such consideration as shall be the fair market value of such shares, and in the absence of fraud in the transaction the judgment of the board of directors as to such value shall be conclusive; or in the absence of fraud in the transaction, for such consideration as from time to time may be fixed by the board of directors pursuant to authority conferred in such articles of incorporation; or for such consideration as shall be consented to or approved by the holders of a majority of shares

then outstanding at any meeting called in the manner prescribed by the by-laws of such corporation, provided the call for such meeting shall contain notice of such purpose. Any and all shares issued as permitted by this section shall be deemed fully paid, and the holder of such shares shall not be liable to the corporation in respect thereof.

Sec. 290c. No corporation authorized to issue shares with no nominal or par value shall begin business until the amount of capital with which it will begin business, as stated in its articles of incorporation or in its articles of incorporation as amended, shall have been fully paid in, nor shall any such corporation, until the capital with which it will carry on business, as stated in its articles of incorporation or its articles of incorporation as amended, shall have been fully paid in, incur any debts in excess of the amount of stated capital paid in at the time such debts are contracted. In case of the increase of the stated capital with which the corporation will carry on business, such increase shall be deemed paid in to the extent of the amount of the assets which the corporation has in money and property in excess of the former stated capital. The directors of the corporation assenting to the creation of any debt in violation of this section shall be liable jointly and severally for the debts of such corporation; but no action shall be brought under the foregoing provision of this section unless within one year after the debt shall have been incurred the creditors shall have served upon the director written notice of intention to hold him personally liable for such debt. Any director who, because of any such

liability under this section, shall pay any debt of the corporation shall be subrogated to all rights of the creditor in respect thereof against the corporation and its property and also shall be entitled to contribution from all other directors of the corporation similarly liable for the same debt and the personal representatives of any such director who shall have died before making such contribution.

Unless it shall have been first permitted or authorized so to do by the commissioner of corporations, no such corporation shall declare or pay any dividend which shall reduce the amount of its stated capital. In case any such dividend shall be declared, the directors in whose administration the same shall have been declared, except those who may have caused their dissent therefrom to be entered upon the minutes of any meeting of the directors at which such action was taken or who were not present when such action was taken, shall be liable jointly and severally to such corporation and to the creditors thereof to the full amount of any loss sustained by such corporation or by its creditors by reason of such dividend.

Sec. 290d. For the purpose of fixing the fee prescribed by section four hundred nine of the Political Code for filing the articles of incorporation of any corporation formed under section two hundred ninety b of this code, the shares of stock of such corporation having no nominal or par value shall be taken to be of the par value of one hundred dollars.

Sec. 290e. In case of any such corporation having capital stock with nominal or par value and capital

stock without nominal or par value, no distinction shall be made between the classes of stock either as to voting power or as to the statutory or constitutional liability of the holders thereof to the creditors of the corporation.

Sec. 290f. Any private corporation formed under the provisions of title one, part four, division one of the Civil Code and now existing or which may hereafter be incorporated under said title may amend its articles of incorporation for the purpose of adopting the provisions of sections two hundred ninety b, two hundred ninety c, two hundred ninety d, two hundred ninety e and two hundred ninety f of the Civil Code, in the manner set forth by the provisions of section three hundred sixty-two of the Civil Code of California as amended.

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2. CALIFORNIA CIVIL CODE SECTION 305, AS AMENDED STATS. 1905, p. 503, CHAP. 392.

305. * * * Directors of corporations for profit must be holders of stock therein to an amount to be fixed by the by-laws of the corporation * * *

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3. CALIFORNIA CIVIL CODE SECTION 362, AS AMENDED 1921, p. 134, CHAP. 134.

362. Any corporation organized under the laws of this State may amend its articles of incorporation for any or all of the following purposes:

(1) To set forth a new name.

*   *   *   *   *   *   *

(8) And generally to provide for any other amendment not contrary to law.

*   *   *   *   *   *   *

Upon the adoption of amended articles of incorporation, a copy of the articles as thus amended shall be certified to as correct by the president and secretary and a majority of the directors of the corporation * * *

The copy of amended articles of incorporation thus certified shall be filed in the office of the secretary of state, whereupon such corporation shall have the same powers and the stockholders thereof shall thereafter be subject to the same liabilities as if such amendment had been embraced in the original articles of incorporation.

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4. CALIFORNIA CODE OF CIVIL PROCEDURE, SECTION 1227, AS AMENDED STATS. 1880, p. 109, CHAP. 86, AND SECTION 1228, AS AMENDED STATS. 1907, p. 318, CHAP. 254.

1227. A corporation may be dissolved by the Superior Court of the county where its principal place of business is situated upon its voluntary application for that purpose.

1228. The application must be in writing and must set forth

1. * * *

2. That all claims and demands against the corporation have been satisfied and discharged.

Appendix C

PERTINENT EXTRACTS FROM CALIFORNIA CORPORATION LICENSE ACT (STATS. 1915, p. 422, CHAP. 190, AS AMENDED STATS. 1917, p. 371, CHAP. 215).

* * * Sec. 3. Except those corporations hereinafter specified, every corporation incorporated under the laws of this state, and every corporation incorporated under the laws of any other state, territory, or foreign country now doing intrastate business within this state, or which shall hereafter engage in intrastate business in this state, shall procure annually from the secretary of state a license authorizing the transaction of such business in this state, and pay therefor the license tax prescribed herein.

* * * Sec. 4. The license hereby provided authorizes the domestic corporations holding the same to transact business in this state, and authorizes foreign corporations to transact intrastate business in this state, during the year or any fractional part of such year for which such license is issued. "Year" within the meaning of this act, means from and including the first day of January to and including the thirty-first day of December next thereafter.

* * * Sec. 6. Corporations organized and conducted solely and exclusively for educational, religious, scientific or charitable purposes, corporations which are not organized or conducted for profit, corporations organized under the laws of any other state, territory or foreign country doing solely and exclusively an interstate or foreign business, and those

corporations taxed under subdivisions (a), (b), and (c) of section fourteen of article XIII of the constitution, are exempt from payment of the tax provided by section three of this act.

* * * Sec. 11. After six o'clock p.m. of the Saturday preceding the first Monday in March in any year, the corporate rights, privileges and powers of every domestic corporation which has failed to pay the tax and money penalty for nonpayment thereof imposed by this act shall, from and after said hour of said day, be suspended, and incapable of being exercised for any purpose or in any manner, except to execute and deliver deeds to real property in pursuance of contracts therefor made prior to such time, and to defend in court any action brought against such corporation, until said tax with all accrued penalties, taxes and charges due to the state under this act and subdivision (d) of section fourteen, article XIII of the constitution are paid as hereinafter provided. The right and privilege of every foreign corporation, subject to the provisions of this act, to transact intrastate business in this state shall, for failure to pay the tax and money penalty for nonpayment thereof imposed by this act, be forfeited at said hour of said day, and the secretary of state shall make a record of such forfeiture. In the case of foreign corporations such forfeiture may be relieved and the corporation's privilege to transact intrastate business in this state restored in the manner hereinafter provided. After said hour of said day and until such taxes, penalties and charges are paid, every person who attempts or purports to exercise any of the

rights, privileges or powers of any delinquent domestic corporation except as permitted by this act, or, who transacts or attempts to transact any intrastate business in this state in behalf of any forfeited foreign corporation, shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not less than two hundred fifty dollars and not exceeding one thousand dollars, or by imprisonment in the county jail not less than fifty days or more than five hundred days, or by both such fine and imprisonment. The jurisdiction of such offense shall be held to be in any county in which any part of such attempted exercise of such powers, or any part of such transaction of business was had or occurred. Every contract made in violation of this section is hereby declared to be void.

Appendix D

RESERVED ARGUMENT.

THE KOSTER PRODUCTS COMPANY WAS NOT A PARTY TO THE REORGANIZATION RESULTING FROM THE TRANSFER OF THE A COMPANY TO THE B COMPANY IN 1924.

The 8,000 shares of stock of the Koster Products Company which the A company transferred in 1924 to the B company and which had been previously acquired by the former at a cost of over $92.00 per share, using $738,374.21 as the base, did not at the time of their transfer in 1924 have a fair market value in excess of $15.00 per share. The transfer from the A company to the B company of all the assets of the former including these 8,000 shares of stock being a transfer under a reorganization as defined in the Revenue Act of 1924 was one in which the A company could assert no loss, for income tax purposes under Sec. 203(b) (3) and Sec. 203(f) of that act. The consideration to the A company for this transfer was stock of the B company, its *alter ego,* issued to the A company and its stockholders, as its nominees. If the B company, as may be suggested by the respondent, had been obliged to carry this stock at a cost of only $15.00 per share as the base for future gain or loss, on the later sale thereof, both companies would be forced to take a loss for which neither might secure any tax relief. The A company can assert no loss arising from the transfer in 1924 by reason of the reorganization in 1924, and the B company, owned by the same interests as the A company, on the sale of the stock in 1925, according to the respondent, would

be obliged to measure its loss with a cost of $15.00 per share as the yard stick for measurement. If the A company had not been obliged to effect a reorganization in 1924, and had sold these 8,000 shares of stock in 1925, just as the B Company did for $8.00 per share, the A company could have asserted a loss of $84.00 per share. But because in the meantime there was a reorganization in the course of which these shares were transferred to the B company, the respondent may suggest that the only loss which the B company can assert is limited to $7.00 per share. The difference between a loss of $84.00 per share and $7.00 per share would therefore be automatically erased from the record to the profit of the Government and the penalty of the taxpayer. As there is nothing unlawful or unethical *per se* in corporate reorganizations and as they are often economically necessary, the mind naturally recoils from such an interpretation of the Revenue Act of 1924 when such arbitrary and inequitable consequences must necessarily follow such an interpretation. In short, it does not seem credible that the reorganization provisions of the Revenue Act of 1924 were framed to penalize taxpayers who might be parties thereto. This naturally suggests a careful analysis of those provisions.

The respondent may suggest that the Koster Products Company was, under Sec. 203(h) (2) of the Revenue Act of 1924, a party to the reorganization of the A company and the B company effected in 1924, and that therefore the B company cannot, under Section 204(a) (7) of the Revenue Act of 1924, claim as the basis for future gain or loss on the sale of the

Koster Products Company stock the basis which it had in the hands of the transferor, the A company. The major premise of such an argument is that the Koster Products Company was a party to the reorganization. If it was not, the whole basis for the suggestion fails. It is our position that the Koster Products Company was not a party to the reorganization effected by the A company and the B company in 1924. The Koster Products Company was certainly not an actor in that reorganization and in any usual and commonly accepted meaning of the phrase it was not therefore a party to that reorganization.

In the analysis which follows, unless otherwise indicated, all references to sections and subdivisions thereof are to the Revenue Act of 1924.

Sec. 203(a) reads: "Upon the sale or exchange of property the entire amount of the gain or loss, determined under Section 202, shall be recognized, except as hereinafter provided in this section."

Unless, therefore, an exchange of property falls within some one of the exceptional cases provided for in the subdivisions which follow (a) in Section 203 the resulting gain or loss must be recognized. Subdivisions (b), (c), (d), (e), (f) and (g) of Section 203 are concerned with those exceptional cases. In some of the paragraphs of those subdivisions the term "reorganization" is used, in other paragraphs that term is absent. Wherever the term "reorganization" is used, it is necessary that the meaning of the term be clear; and a definition is found in subdivision (h) of Section 203. This definition, therefore, is obviously intended to clarify and make definite the term "reor-

ganization", wherever that term is used in the section; and this definition, as obviously, can have no other purpose. Any fair interpretation of the statutory definition of a "reorganization" must necessarily be related to the paragraphs of Section 203 which it is intended to make clear, plain and definite. The term "reorganization" is used in Section 203, in subdivision (b) in paragraphs (2) and (3), in subdivision (c), in subdivision (d) in paragraph (2), in subdivision (e) and in subdivision (g). Subdivision (d) in paragraph (1) refers to subdivision (b) in paragraph (2) where the term "reorganization" is used and subdivision (f) refers to subdivision (b) paragraphs (2) and (3) in both of which the term "reorganization" is used. Any definition of "reorganization" as that term is used in subdivision (b) in paragraphs (2) and (3) thereof would fully cover and explain all references to that term in the other paragraphs or subdivisions of Section 203, as the mere perusal of them will manifest. The two important paragraphs of Section 203 so far as the effect of a reorganization upon the recognition of loss or gain is concerned are paragraphs (2) and (3) of subdivision (b). The other paragraphs and subdivisions of Section 203 preceding the definition of subdivision (h) are either not concerned with the effect of a reorganization or are refinements of the general provisions of paragraphs (2) and (3) of subdivision (b).

Those two paragraphs of subdivision (b) read as follows:

> "(2) No gain or loss shall be recognized if stock or securities in a corporation a party to a

reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

"(3) No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

Under the provisions of subdivision (b), paragraph (1) of Section 203 no gain or loss shall be recognized "if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation", and no gain or loss would be recognized on such limited exchanges quite apart from any question of reorganization. But if common stock in a corporation is exchanged solely for preferred stock in the same corporation, as might be the event in case of a recapitalization, gain or loss would be recognized, unless the exchange fell within the exception noted in paragraph (2) of subdivision (b). But that exception is limited to a case where there is a reorganization. In subdivision (h) of Section 203 it is provided that as used in that section the term reorganization, among other things, means a recapitalization.

Except as paragraph (2) of subdivision (b) covers certain cases of an exchange of stock or securities of a corporation solely for stock or securities of such corporation it is confined to cases of an exchange, pursuant to a plan of reorganization, of the stock or secu-

rities of one corporation solely for the stock or securities of another corporation, with the added condition that both corporations, parties to the exchange, must be parties to the reorganization. In such an exchange of stock of one corporation for the stock of another, it is obvious that both corporations are actors in the transaction and are parties to a contract of exchange.

Paragraph (3) of subdivision (b) is confined to cases of an exchange pursuant to a plan of reorganization of the property of one corporation solely for the stock or securities of another corporation, with the added condition that both corporations, parties to that exchange, must be parties to the reorganization. In such an exchange of the property of one corporation for the stock of another it is again evident that both corporations are actors in the transaction and are parties to a contract of exchange. Given a statutory definition of a reorganization there would be no difficulty in identifying the two corporations as parties to the reorganization who were parties to an exchange of the stock of the one for the stock of the other, or of the property of the one for the stock of the other, where the exchange was made pursuant to a plan of the reorganization.

To a full understanding of the scope of these two paragraphs (2) and (3) of subdivision (b) it is only necessary to have a clear and authoritative definition of the term reorganization.

An exchange of the stock or securities of one corporation for the stock or securities of another, or an

exchange of the property of one corporation for the stock or securities of another may be the form, in whole or in part, which a merger or a consolidation may take. Both a "merger" and a "consolidation" are included in the statutory definition of the term reorganization; Sec. 203, subdivision (h) (1) (A). There would therefore be no gain or loss recognized in an exchange either (1) of the stock or securities or (2) of the property of one corporation, party to a merger, solely for the stock or securities of another corporation, party to the merger, where the exchange was made pursuant to the plan of merger. And what is thus true of a merger would be equally true of a consolidation. There would, however, be no difficulty in identifying the two or more corporations, parties to such an exchange, as the parties to such a merger or consolidation and as therefore the parties to the statutory reorganization.

A corporation may also reorganize within the statutory definition, if it transfers all or a part of its assets to another corporation, if immediately after the transfer the transferror or its stockholders or both are in control of the corporation to which the assets are transferred—Sec. 203 (h) (1) (B)—and "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of all other classes of stock of the corporation—Sec. 203 (i). If a corporation, pursuant to a plan to that effect, transferred all of its property to another corporation solely in exchange for stock in the other corporation, and immediately after the transfer the first corporation was in the statutory

control of the second, there would be a statutory reorganization and there would be no gain or loss recognized in the exchange. There would be no difficulty in identifying these two corporations, parties to such an exchange, as the parties to the statutory reorganization.

If a corporation recapitalized, or effected a mere change in identity, form, or place of organization, such a change, though amounting to a statutory reorganization—Sec. 203 (h) (1) (D)—would have no effect upon the recognition of gain or loss unless in connection therewith there had been an exchange of stock or securities for stock or securities, or an exchange of property for stock or securities. If, as the result of a recapitalization noted in clause (C) or some of the other changes noted in clause (D), the only corporation concerned exchanged its own securities for its own stock or exchanged its own common for its own preferred stock, there would be no recognition of gain or loss, if it were a party to a reorganization. To avoid any difficulty which there might be in identifying such a single corporation as a party to such a reorganization as is recognized in clauses (C) and (D) which merely exchanged its own securities, Section 203 (i) declares in substance that the corporation emerging or resulting from a change in its capitalization, form, identity or place of organization, however effected, should be included in the term "a party to a reorganization".

Thus subdivision (h) (1) defining a reorganization is concerned with two or more corporations dealing

with each other through exchanges of securities and property in the case of a "merger" or "consolidation" under clause (A), or in the case of a "transfer" under clause (B); and is concerned with a single corporation effecting a "recapitalization" under clause (C) or a "mere change in identity, form or place of organization, however effected" under clause (D).

Section 203 (h) (1) reads in part as follows, "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) or (B) etc.

It would be most surprising if the parenthetical addition of the "acquisition" clause to clause (A) were intended to cover any "acquisition" except that by way of an exchange of securities and properties between two corporations, similar in character, if not in degree, to the exchanges necessarily involved in a "merger" or a "consolidation". The fact that the "acquisition" clause was added to the "merger" and "consolidation" reference by way of parenthesis and that it is introduced by the significant word "including" suggests with further emphasis that the Congress had in mind in the "acquisition" clause merely another case of an exchange of property and securities between two corporations, having some of the practical characteristics, so far as gain or loss might be concerned, but lacking the complete form of a technical "merger" or "consideration".

Mergers and consolidations are purely statutory in character. But the acquisition by one corporation of a majority of the voting and other classes of stock of another, or of substantially all of the properties of another corporation, while falling short of a technical merger or consolidation, is a situation in which it is equally as fair that no gain or loss should be recognized, where there was an exchange of stock of one corporation solely for stock of another, or an exchange of property of one corporation solely for stock of another, as in the case of a technical merger or consolidation.

It is difficult to believe that in the "acquisition" clause parenthetically included in clause (A) the Congress could have deliberately intended to define a "reorganization" in such broad terms as to embrace a corporation arbitrarily within a statutory reorganization which was not directly affected thereby, which had no voice in the planning of the reorganization, and which did nothing to make it effective. We suggest therefore that the acquisition by one corporation of the prescribed majority stock of another or of substantially all the properties of another corporation to amount to a statutory reorganization must be limited to the case of such an acquisition by one from the other. This must necessarily be the case where one corporation acquires substantially all the properties of another, because there is no way by which one corporation could acquire the properties of another except from that other. In the case of acquiring stock or acquiring property, the matter of ex-

change is involved, unless the transaction is solely on a money basis, the latter a situation with which we are not concerned in interpreting the statute. There is no good reason for supposing that it was the legislative intent that this element of a mutual exchange might be absent from the acquisition of stock when it must necessarily be present in the acquisition of property. The necessary limitation on the acquisition by one corporation of the property of another from that other in exchange for something going to that other corporation implies a similar limitation on the acquisition by one corporation of the prescribed majority of stock of another corporation to the case where it was acquired from that other corporation in exchange for something going to that other corporation. In short, before an acquisition by one corporation of the prescribed majority stock of another can amount to a reorganization, that stock must be transferred by the other corporation to the corporation acquiring it in exchange for securities or property of the acquiring corporation transferred to the other corporation or its nominees. Whether the corporation transferring the prescribed majority stock issues it from its treasury stock or secures it from its stockholders is of no significance. But the element of a mutual exchange is essential, for only out of the exchange arises the question of the recognition of a gain or loss to answer which paragraphs (2) and (3) of subdivision (b) of section 203 were prepared, but which in turn depend for clarity and definiteness upon the meaning of the term "reorganization", which in its turn is defined in subdivision (h).

The meaning which we suggest as the proper meaning of the parenthetical "acquisition" clause of clause (A) of subdivision (h) (1) is consistent with the main purpose of that subdivision, is consistent with the text of subdivision (h), with its position in that subdivision, with its parenthetical addition and with its introductory word "including". It avoids the inconsistency of having the necessary limitation on the acquisition of property differ from the limitation on the acquisition of the prescribed majority stock. Finally it avoids imputing to the Congress any intent to impose the arbitrary and inequitable consequences upon the taxpayer which must result from the interpretation suggested by the respondent.

Under the interpretation which we suggest, the acquisition of stock of the Koster Products Company by the B company from the A company would not amount to a statutory "reorganization" so far as the Koster Products Company was concerned. The Koster Products Company was not a party to that "acquisition", which concerned only the A company and the B company and the Koster Products Company was therefore not a party to any reorganization in 1924. The definition of "a party to a reorganization" as including both corporations in the case of the acquisition of the prescribed majority stock of another corporation was never intended to enlarge the meaning of the term "reorganization", or to declare corporations as parties to a reorganization when in fact there was no reorganization. All that Section 203 (h) (2) intended is that where the acquisition of stock or property occurs under circumstances within

the definition of a reorganization both the corporation acquiring and that transferring the stocks or property are to be deemed parties to the reorganization.

The Koster Products Company was not a party to the reorganization effected by the A company and the B company in 1924, and the stock of the Koster Products Company acquired by the B company from the A company in 1924, was like the other property acquired from the A company by the B company in 1924, entitled to the same basis for determining gain or loss that it had in the hands of the transferror—Sec. 204 (a) (7).

Appendix E

CORRECTED FIGURES FOR STATUTORY NET LOSS.

The B company claimed the loss in 1925 at $846,461.85. In making that claim it had through error used as the cost figure of the property exchanged for the stock of the Koster Products Company the sum of $910,701.85 (Ex. 4) and through error had set up $64,240.00 as the amount received by the B company on the sale of this stock in 1925 (Ex. 4) instead of $64,400.00. Exhibits 4, 6 and 7 show how the loss and the statutory net losses were figured as follows:

	1925	1926	1927
Cost	$910,701.85		
Amount received	64,240.00		
Loss	846,461.85	$504,502.66	$306,348.56
Applied against income	341,889.19	198,154.10	110,486.33
Balance unapplied	504,572.66	306,348.56	195,862.23
Dividends	70.00		
Statutory net loss	$504,502.66	$306,348.56	$195,862.23

Correcting these figures and using the adjusted cost figures of $738,374.21 which is the cost less depletion and depreciation and exclusive of carrying charges (Ex. 1, Trans. pp. 52, 53) the loss and the statutory net losses would be as follows:

	1925	1926	1927
Cost	$738,374.21		
Amount received	64,400.00		
Loss	673,974.21	$332,015.02	$133,860.92
Applied against income	341,889.19	198,154.10	110,486.33
Balance unapplied	332,085.02	133,860.92	23,374.59
Dividends	70.00		
Statutory net loss	$332,015.02	$133,860.92	$ 23,374.59

The balance of statutory net loss of $23,374.59 is the unextinguished balance remaining after applying the statutory net loss against 1927 income.